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Mr. Keynes' Views on the Transfer Problem

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MR. KEYNES' VIEWS ON THE TRANSFER PROBLEM

I. A CRITICISM BY M. JACQUES RUEFF

IN the ECONOMIC JOURNAL for March, 1929, there appeared an article by Mr. Keynes on "The German Transfer Problem." In this article Mr. Keynes answers those writers who believe that the transfer problem does not arise when budgetary problems have been solved, and that it may even be dangerous to provide machinery to maintain the equilibrium of the balance of payments of the debtor country.

This article, like all that Mr. Keynes writes, is argued with incomparable logic. The problem is clearly defined, the reasoning unfolds itself with such lucidity that the contrast between the two points of view is sharply distinguished, and discussion becomes particularly inviting. If any excuse is needed for having undertaken this discussion, it may be found in the very perfection of Mr. Keynes' dialectics.

In Mr. Keynes' criticism of the standpoint of the writers who deny the existence of a transfer problem there are two fundamental observations, differing greatly both in character and in their respective consequences.

In the first, Mr. Keynes shows that, in his view, the settlement of reparations due from Germany raises not only a budget problem, but also a transfer problem, because "the expenditure of the German people must be reduced, *not only* by the amount of the reparation taxes which they must pay out of their earnings, but also by a reduction in their gold-rate of earnings below what they would otherwise be. . . . The transfer problem consists in reducing the gold-rate of efficiency-earnings of the German factors of production sufficiently to enable them to increase their exports to an adequate aggregate total; the budgetary problem consists in extracting out of these reduced money-earnings a sufficient amount of reparation taxes" (p. 4).

On this point Mr. Keynes' assertion appears to be indisputable. But it is equally so when he says on page 5: "The reduction in real wages would be by no means so large as the reduction in money-wages, since the prices of home goods for home consumption might be expected to fall."

This seems to us an essential point. If it were possible to examine here the question from the point of view of economic theory, by inquiring how equilibrium is maintained or restored, provisionally ignoring the resistances which in practice paralyse the play of economic phenomena, it could be shown that exchange and price movements—in other words, the movements of gold prices—which tend to maintain the equilibrium of a balance of payments, or restore it when it has been accidentally disturbed, affect equally all internal prices.

This is evident when, during a régime of forced currency, a variation in gold prices is brought about by means of a variation in the rate of foreign currencies reckoned in the national currency. In the case of metallic circulation the proof is more complicated, and constitutes a special aspect of the theory of prices; but we are sure that Mr. Keynes knows the result and does not dispute it. Assuming then that, in the adjustment which restores equilibrium to the balance of payments all the prices vary in the same proportion as wages, real wages are not modified. Hence the purchasing power of the population remains unchanged, and the fall in gold prices which restored the equilibrium of the balance of accounts has imposed no new sacrifice on the population, and has not altered its position in any way. As, moreover, this movement of prices is entirely spontaneous, we consider that it can be altogether ignored. It was for this reason that we felt justified in asserting that there was no transfer problem.

On the contrary, the levy which is to produce the necessary funds for the purchase of the exchange to be remitted to the foreign creditor will cause no fall in prices, since the purchasing power of which the population has been deprived will be transferred to the sellers of foreign exchange and utilised by them. As a result of this levy, there will therefore be a real decrease in the resources of the population of the debtor State, and this decrease, measured in purchasing power, will be exactly equal to the increase in the resources of the population of the creditor State.

The foregoing conclusions can also be deduced from a principle which I have always found confirmed in the various individual cases I have had to study. I should be astonished if Mr. Keynes had not, like myself, had occasion to enunciate this conclusion and if he did not admit its general applicability. This principle, which might be called the principle of the conservation of purchasing power, simply states that never in the course of the various economic transformations that occur is purchasing power lost or created, but that it always remains constant. The result is that in all cases one man's loss is another man's gain, as was very clearly shown by the levies made upon the holders of fixed income securities during the various inflation crises which followed the war. In the case before us the principle of the conservation of purchasing power makes it possible to assert that, whatever the appearances may be, the population of the debtor State would not suffer a loss of purchasing power greater than the amount of their debt—a conclusion to which the theory of exchanges and prices would lead.

For all these reasons I have ventured to assert that, at any rate as a matter of economic theory, there is no transfer problem, but only a budgetary problem. And I think that Mr. Keynes will also agree with me in this. But he will observe—and this is his second criticism—that the results mentioned above are true only in economic theory, when it is assumed that all phenomena have free play and are not subject to all the resistances and frictions which in reality paralyse their operation. "In the case of German reparations," he says, "we are trying to fix the volume of foreign remittances and compel the balance of trade to adjust itself thereto. Those who see no difficulty in this . . . are applying the theory of liquids to what is, if not a solid, at least a sticky mass with strong internal resistances" (p. 6).

Thus, Mr. Keynes does not deny the existence of the phenomena which tend to maintain economic equilibria, but he holds that these phenomena are unable to overcome the resistances which in practice oppose the adjustments they tend to bring about. In other words, when the equilibrium of a balance of accounts has been disturbed—as it is by the payment of a new debt of a political character—there will, it is true, be a tendency towards the restoration of this equilibrium; but to be effective this tendency will have to modify existing situations and, in particular, bring about profound changes in commercial currents. Mr. Keynes refuses to admit that the stuff of economics is sufficiently fluid to obey rapidly and without profound disturbances the influences of a non-economic origin which tend to shape it. He considers in particular that the balance of trade at any moment is largely dependent upon the economic structures of the various countries, and that it cannot adjust itself rapidly to the requirements of an equilibrium in the balance of payments when the conditions of this equilibrium are abruptly modified.

By means of the foregoing considerations, Mr. Keynes defines the problem with abundant clearness. He thinks that the writers who deny the existence of a transfer problem are wrong in stating that the balance of payments of a country is always brought into equilibrium by the operation of the phenomena of exchange and prices, and that therefore, when the invisible factors of the balance of payments undergo an important change, the commercial balance spontaneously undergoes a change in the opposite direction.

If Mr. Keynes is right, there is a transfer problem, and it is necessary continually to limit actual transfers to the transfer possibilities of the moment; if, on the other hand, he is wrong, it is the previous transfers which determine the conditions of equilibrium of the balance of payments, and it would be absurd to attempt to make actual transfers dependent on the transfer possibilities which they themselves create.

To settle the question, it will be sufficient to interrogate the facts and to inquire whether, in previous cases in which the equilibrium of the balance of payments has been abruptly disturbed the commercial balance has obeyed the phenomena which tend to maintain the equilibrium of the balance of payments, or whether, on the contrary, the adjustment of the commercial balance has been rendered impossible by those resistances which Mr. Keynes alleges to exist.

Thus, past experience will tell us in each case the amount of truth contained in Mr. Keynes' assertions, who, as if to help us in examining his contention, has further defined its meaning as follows :—

"My own view is that at a given time the economic structure of a country in relation to the economic structure of its neighbours permits of a certain natural level of exports, and that arbitrarily to effect a material alteration of this level by deliberate devices is extremely difficult" (p. 6).

This judgment contains a two-fold assertion, firstly that for each country there is a "natural" level of exports, determined by the economic structure of the different countries concerned, and secondly that it is extremely difficult to effect an alteration of this level arbitrarily and deliberately.

I shall first endeavour to refute this second assertion, and will then go on to examine the first. In the course of this discussion I shall have to have recourse to arguments I have already used in a previous study,[1] with which I think Mr. Keynes is already acquainted. I have the less scruple in doing so as Mr. Keynes' article shows me that I did not sufficiently bring out the

[1] Une erreur économique : l'organisation des transferts (Doin, 1928).

lessons to be derived from this study as regards the sensitiveness of economic phenomena, and particularly as regards the adaptability of balances of payments to certain deliberately provoked situations.

In this work I examined, among other things, the phenomena which followed the most profound and abrupt disturbance ever suffered by a balance of payments—that which was produced by the decision suddenly taken by Great Britain and the United States at the beginning of 1919 to cease granting France the sterling and dollar credits which had previously enabled France's balance of payments to be kept in equilibrium. This decision removed from the credit side of this balance of accounts an item of approximately 20 milliards of francs. To use Mr. Keynes' own words, it was "arbitrary" and a "deliberate device."

If our author's contention was correct—in other words, if, as he says, a country's balance of payments is the result of the economic structure of the countries concerned—and if it were extremely difficult to effect a material alteration in the natural level of exports by a deliberate device, France's commercial balance should not have been modified. It should have remained, after the removal of the credit, materially what it had been before, since the economic structure of the countries concerned was not affected by the free decision of the British and American Governments. If this had been so, the deficit in France's balance of payments would have been approximately 20 milliards of francs per annum.

The facts show, however, that this was by no means the case. In 1919 the deficit in France's commercial balance was approximately 23 milliards of francs. In 1920 it was approximately the same. But in 1921 it had been reduced to approximately 2 milliards of francs, and remained more or less at that level during 1922 and 1923.

In other words, following upon the cessation of the credits which France received from her Allies, a change had taken place in her commercial balance very nearly equal to the amount of the credits withdrawn, this change making up for their disappearance and restoring an equilibrium whose disturbance had nevertheless been deliberate.

It should further be observed that if in 1919 equilibrium was re-established during a period of currency depreciation, this depreciation was not in any way an essential factor of the phenomena which brought about the re-establishment of equilibrium. The latter results from a reduction of internal prices as compared with external prices estimated in the national currency, and this diminution may be caused not only by a rise in the rate of foreign exchange, but also, to a period of free circulation of gold, by a small fall in home prices. The above observation is developed in the work already referred to.

Mr. Keynes will no doubt think that the re-establishment of the equilibrium in the balance of payments in France between 1919 and 1921 constitutes a mere coincidence. The change in the commercial balance which seems to make up for the withdrawal of the political credits may, according to him, be only the transition from the " natural level " of the state of war to the " natural level " of the state of peace, and may have simply been caused by the changes in economic structure attending this transformation.

If this were so, it would still be somewhat surprising that the change in the commercial balance should coincide approximately with the amount of the credits withdrawn. But, further, the commercial balance should remain more or less constant after this movement, or rather it should only undergo changes provoked by modifications in the economic structure of the countries concerned.

The facts, however, were quite otherwise. France's commercial balance remained practically constant during 1921, 1922 and 1923 (deficit, in millions of francs, 2,295, 2,552 and 2,256). But during 1924 it underwent a further striking change, and showed no longer a deficit, but a surplus of 1,540 million francs.

Now everyone knows that the end of the year 1923 witnessed in France the beginning of the great period of the exportation of capital. This introduced a new debit item in the balance of payments. If therefore the commercial balance had remained unchanged, the balance of payments would have shown a deficit. To bring about equilibrium, a modification of the commercial balance was necessary. Now this modification displayed itself in the clearest possible manner, although never since 1875 had the Customs statistics revealed in France a surplus of exports over imports.[1] This surplus was maintained during the year 1925 (1,660 million francs). During 1926 it fell to 80 millions, and again rose in 1927 to 1875 million francs. But from 1928 onwards, *i.e.* from about a year and a half after the end of the great capital export crisis,[2] the deficit reappeared. It amounted

[1] Except, however, in 1905, when there was an exceptional surplus of 88 million francs.

[2] After the withdrawal of the political credits it also took about one and a half years for the commercial balance to adjust itself.

to 2,101 million francs, *i.e.* it returned to about the figure of the years 1921, 1922 and 1923, during which it was generally acknowledged that in France there was no movement for the export of capital.

Thus, during all this period France's commercial balance has always adjusted itself very definitely to the modifications in the financial factors of the balance of payments (first political credits and then investments abroad), although these modifications were extremely rapid and involved exceptionally large amounts, and although they had no relation to what Mr. Keynes calls the economic structure of the countries concerned.

The fact that the commercial balance adjusted itself to the quite exceptional volume of investments abroad during the great crisis of exportation of capital which occurred in France for psychological reasons definitely invalidates the opinion which Mr. Keynes expressed as follows—(p. 6 of his article) :—

"Historically the volume of foreign investment has tended, I think, to adjust itself, at least to a certain extent, to the balance of trade rather than the other way round, the former being the sensitive and the latter the insensitive factor." We have just shown that in France, after the war, the exact contrary proved to be true.

At all times, in fact, the commercial balance has shown a tendency to adjust itself to the necessities of the equilibrium of the balance of payments, whatever they might be and whatever their origin. Between 1870 and 1914, for instance, France's commercial balance only showed a surplus during the period 1872–1875, during which France was rapidly paying off the war debt imposed upon her by Germany; while during all the rest of this period the commercial balance showed a deficit of several hundred million francs per annum.[1]

[1] With the exception, however, of the year 1905, during which the commercial balance showed a surplus of 88 million francs. For the period 1867–1887 the figures are as follows :—

Year.	Commercial balance.	Year.	Commercial balance.
1867	−201	1877	− 243
1868	−514	1878	− 997
1869	− 79	1879	−1,364
1870	− 65	1880	−1,566
1871	−694	1881	−1,302
1872	+191	1882	−1,247
1873	+233	1883	−1,353
1874	+194	1884	−1,111
1875	+336	1885	−1,000
1876	−413	1886	− 960

It should be pointed out, however, that during the previous period France's

Clearly there could be no question of a modification of what Mr. Keynes calls the "natural" level of exports, as the needs not satisfied during the war obviously tended to increase the deficit in the commercial balance during the period following the close of hostilities. The appearance of a surplus at a time when all the resistances invoked by Mr. Keynes should have made it impossible, although it was a necessary condition of the equilibrium of the balance of payments, provides a fresh example of the extreme elasticity of economic matter and of its powers of adaptation, even when the disturbing phenomenon is "arbitrary" and "artificially produced."

The modifications undergone since the war by the various balances of payments provide, moreover, a still more decisive proof of the extraordinary power of the machinery which tends to maintain the equilibrium of balances of payments or to restore it when it has been artificially disturbed.

At the same time they permit us to form an estimate of Mr. Keynes' judgment that "at a given time the economic structure of a country in relation to the economic structure of its neighbours permits of a certain 'natural' level of exports."

In 1913 France's commercial balance showed a deficit of 1,540 million francs. This deficit was practically the same as that of 1912 (1,518 million francs). The situation which it indicated was the outcome of entirely normal conditions.

After the war, on the contrary, a quarter of the national territory—and the area which furnished France with by far the greatest proportion of her exports—had become unproductive. At the same time, an immense market with almost boundless requirements was created within the country for the reconstruction of the devastated areas.

For all these reasons, the country should have found extreme difficulty in exporting and could have imported to an unlimited extent. The "natural level" of the commercial balance, that resulting from the economic structure of the different countries concerned, should have involved a deficit much greater than before the war. If, therefore, Mr. Keynes' views were correct, there should, in fact, have been such a deficit.

commercial balance sometimes showed a surplus—for instance, from 1862 to 1866. But it is obvious that the payment of a foreign debt can only appear in the commercial balance if all conditions are equal with regard to the invisible elements of the balance of payments. What is remarkable in the case of France after 1870 is that a surplus appeared in the commercial balance at precisely the moment when theory would lead one to expect it. This only constitutes a presumption—but a very strong presumption—in favour of the said theory.

It is true that if such a deficit existed it would have produced a deficit in the balance of payments of the country, since clearly the invisible assets of this balance of payments were not greater after the war than before. This, however, is impossible according to the writers who maintain that the balance of payments of a country is always in equilibrium.

Further, if the views of these writers are correct, the deficit shown in 1912 and 1913 by France's commercial balance must have been compensated by a surplus of invisible exports, and it was generally acknowledged that before the war the great part of this surplus was formed by the income from foreign investments held by Frenchmen. During the war, however, these holdings greatly diminished. Many of the foreign securities which they comprised were handed over to the Government at its request, in exchange for French bonds, and were disposed of by it. Others, particularly Russian securities, became unproductive. If therefore the deficit of the commercial balance had remained after the war what it was in 1913, France's balance of payments would certainly have shown a deficit also. For this balance to be brought into equilibrium—and the writers whom Mr. Keynes criticises consider that, whatever the resistances of the economic milieu, a balance of payments is bound to be in equilibrium [1]—it was essential that after the war, in spite of all adverse circumstances, the deficit in the French commercial balance should be lower than what it was in 1913.

Here, therefore, we have a crucial test of the two theories, that of Mr. Keynes and that of the writers who deny the existence of a transfer problem. If France's commercial balance since the war shows a greater deficit than in 1913, the theory of the "natural" level must be true. Otherwise it is the theory which Mr. Keynes criticises that must be accepted.

The deficit of 1,540 million francs for 1913 was equivalent to about 297 million dollars.

In 1921, on the other hand, imports exceeded exports by 2,295 million French francs. The average rate of the dollar in francs during the same year was 13·49. Hence the deficit in the commercial balance represented approximately 170 million dollars, or 57 per cent. of the 1913 figure.

In 1922 the deficit in France's commercial balance was 2,552 million French francs, and the average rate of the dollar was

[1] Except during a period of budget deficits or flight from the currency. It is clear that when the holders of foreign currency do not repatriate the equivalent, equilibrium can never be attained.

frs. 12·33. The deficit in the commercial balance was therefore 206 million dollars, or 69 per cent. of the 1913 figure.

This result would be still more striking if we took into account the level of prices rather than the rates of exchange in comparing the deficits before and after the war.

Thus, despite the most unfavourable circumstances imaginable, the deficit in France's balance of trade was very materially lower in 1921 and 1922 than it was in 1913, although during the former period the reduction in the country's productive capacity, owing to the entire destruction of its most active factories on the one hand, and its enormous reconstruction needs on the other hand, would have led one to expect a considerable increase in the deficit in its commercial balance.

This unexpected result seems to decide between the two theories by showing that the most powerful "natural" resistances cannot prevent the restoration of the equilibrium of the balance of payments, even when the equilibrium has been disturbed by events of a purely financial nature. It shows, moreover, that the notion of a "natural" level of exports is a complete fallacy and cannot legitimately be invoked.

This conclusion would be brought out still more clearly if we could analyse here the machinery by which the equilibrium of the balance of payments is maintained in current practice. We have attempted this analysis elsewhere.[1] Suffice it to say that it led to the conclusion that, apart from periods of "flight from the currency" and of budget deficits, exchange and price movements tending to maintain the equilibrium of the balance of payments are bound to be effective, as they are bound to go on until the previous equilibrium has been completely re-established.

The same theory provides an answer to Mr. Keynes' objection that the raising of foreign Customs tariffs might make it impossible to restore the equilibrium of a balance of payments by making the increase in exports required for this restoration impossible. It is quite clear, of course, that if there is a machinery tending to restore the equilibrium of balances of payments when it has been accidentally disturbed, this machinery must prevent the raising of the customs barriers which surround a country from modifying that country's balance of commercial exchanges.[2] This is indeed

[1] "Théorie des Phenomènes Monétaires" (Payot, Paris), 2nd Part—and particularly Chapter VIII, §§ 2, 3 and 4. A summary of the theory was given in the pamphlet mentioned above: "Une erreur économique: l'organisation des transferts" (pp. 10 *et seq.*).

[2] We are speaking here only of the commercial balance, *i.e.* the difference between the value of imports and that of exports. It is clear, of course, that a

evident *a priori*, for if a change in Customs duties affected commercial balances, it would be possible, by raising simultaneously *all* Customs tariffs, to make *all* commercial balances show a surplus, which is absurd. As this is impossible, there must be machinery which prevents changes in Customs tariffs from disturbing the equilibrium in balances of payments, and this machinery is bound to be effective at whatever level Customs duties are fixed. In the work mentioned above,[1] we have shown that experience very clearly confirmed the accuracy of these theoretical views when the United States put a new Customs tariff into force in 1922.

Thus, in the different examples we have considered, the equilibrium of the balance of payments has always been restored, whatever the extent of the initial disturbance and however arbitrary it may have been.

We do not say, however, that unlimited sums could be transferred from one country to another; we simply observe that in the cases we have just studied the disturbance in the equilibrium of the balance of payments was greater than that which would result from the normal application of the Dawes Plan, and that equilibrium was always spontaneously restored without interference of any kind.

A complete theory of the phenomenon would show, however, that only sums taken from the resources of a balanced budget could be transferred. It would also indicate, as was said before, that monetary depreciation is by no means essential to the operation of the phenomena which restore the balance of payments to equilibrium.

We do not, however, desire to go into such considerations here. The chief aim of the present study was to gauge the truth contained in Mr. Keynes' assertion that to deny the existence of a transfer problem was to apply the theory of liquids to what in reality was, if not a solid, at least a sticky mass.

In every case, however, we have seen economic matter adjust itself with extraordinary elasticity to the influences to which it was subject, whatever their origin, and always, too, we have seen the phenomenon which theory taught us to expect govern the

modification in the Customs tariff, by modifying the relative prices of the various foreign goods, modifies the exchanges of these goods and therefore modifies the constitution and value of the imports and exports, only the difference between their total values remaining constant.

[1] The monetary repercussions of a Customs policy: the application of the Fordney tariff in the United States in 1922.—*Op. cit.*, p. 305.

facts which responded in the most sensitive manner. Fluidity of the economic mass, sensitiveness of the phenomena which occur therein, these we regard as two essential observations of infinitely greater consequence than the transfer problem.

To believe, indeed, that resistances due to the very nature of things can prevent economic equilibria from spontaneously establishing or maintaining themselves, is to force oneself to admit the necessity of establishing them by concerted and systematic measures similar to those which would have to be taken by the Transfer Committee to ensure the equilibrium of Germany's balance of payments on the lines of the Dawes Plan. Such a conception leads inevitably to the practice of an *organised economy* similar in principle, if not in object, to the Communist economy.

To admit, on the other hand, that economic phenomena, left to themselves, are able in actual fact to restore or maintain with great exactness the necessary equilibria, leads to the view that the only effective means of avoiding or attenuating economic crisis is to remove or attenuate any obstacles which may stand in the way of spontaneous adjustment, and to avoid all measures which tend to immobilise the various factors of economic equilibrium.

Thus, to gauge the actual sensitiveness of economic phenomena, is to seek the solution of perhaps the most important political problem at present awaiting issue, that of the choice between the two tendencies of liberal economy and organised economy. It is on this ground that the question raised by Mr. Keynes—that of the mobility of economic equilibria—has seemed to us fundamental from the political point of view still more than from the point of view of economic theory. We have endeavoured to answer it in the limited sphere of international exchanges; we believe that it is worth systematic study in all spheres of economic life. Perhaps we shall endeavour in a future article to show that the conclusion we have reached is an extremely general one, and that in almost every case a systematic observation of the facts reveals the existence of economic phenomena attaining an unsuspected degree of sensitiveness and permanence.

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II. A Rejoinder from Professor Ohlin

§ 1. Mr. Keynes' theory of reparation payments and capital exports, as expressed in the last two numbers of this Journal,[1] in my opinion amounts briefly to this: the expansion of commodity exports relative to imports, which is necessary in the indemnity paying and lending countries, is brought about by an adaptation of *supply* conditions only. Wages must fall and, thereby, the costs and supply prices of export goods. International capital movements—under this expression I include also reparation payments—do not involve any changes in *demand*,[2] which tend to bring about the relative increase of exports.

Against this theory I have objected that such capital movements mean increased buying power in the borrowing (receiving) country—below called *A*—and reduced buying power in the lending (paying) country, *B*. Is it not obvious that the buying power of a country, like that of an individual, will exceed its (his) income by the amount of gifts and loans, quite independently of any changes in price levels?

Mr. Keynes' answer to this question is in the negative. There will be an increased buying power in *A* only in so far as *B*, through *lower supply prices*, is able to create a relative increase in exports. Then, however, this increased buying power "will have been *already* used up in buying the exports, the sales of which has made . . . payments possible" (p. 181). In other words, in Mr. Keynes' opinion, there can be no transfer of monetary buying power except in so far as the *real* transfer of goods is solved—*i.e.* the increase of exports relative to imports brought about—and then the buying power is at the same time used up. Therefore the monetary transfer cannot be a factor in bringing about the real transfer.

§ 2. To make clear why I think this is profoundly wrong, let me consider first a case of capital movements between two districts with the same currency system. Assume that *A* and *B* are parts of one country, and disregard the possibilities of labour migration between them.

A borrows a large sum of money from *B* to build a railway. It can take the money in notes or in cheques, whereby the deposits in the *A* banks grow, while they fall off in the *B* banks. In any case the buying power is increased in *A* and reduced in *B*, inde-

[1] See particularly p. 181 in the June issue.

[2] For qualifications to this statement, see § 4 below.

pendently of any commodity movements and certainly *before*[1] they take place. The monetary transfer is primary to the real transfer, and tends to bring the latter about in the following way: *A* buys more and *B* less of the goods which go easily between them ("international goods"), whereby the "trade balance" is directly affected. Furthermore, people in the former district use a part of the increased buying power to purchase "home market goods," which become more demanded than before, while the same class of goods becomes less demanded than before in *B*. Their prices may rise in *A* and fall in *B*, but whether these price changes are considerable or not, production of such goods is expanded in the former and reduced in the latter district, while the production of "international" goods moves in the opposite direction, *i.e.* is reduced in *A*. In that way *A*'s imports increase and its exports fall off. *B*, on the other hand, will buy less and is able to sell more without offering its own export goods on cheaper terms of exchange than before.

It is the very fact that buying power is greater than incomes in *A* and lower than incomes in *B*, which brings about the necessary commodity movements. Yet Mr. Keynes reasons all the time as if a country could not buy for more than its income, and as if the only way of changing its buying power were to change its income.

§ 3. Let us return now to the case of *A* and *B* being separate countries with different currency systems. The only essential difference between this and the last case is that no transfer of monetary buying power in a literal sense can take place, except in the form of gold. As, however, gold movements are clearly insufficient, the same result will be reached in another way. Credit will expand in *A* and fall off in *B*. The foreign bills—let us assume them to be in the currency of a third country[2]—which *A* receives from *B* will, *e.g.*, be bought by the central bank in the former district. If its gold reserves are too small for this expansion, it will let the exchange rate drop to the gold import point. When sufficient gold has come in, it will again buy the foreign bills, and the volume of credit will expand. In *B* the buying power is directly reduced by the purchases of foreign bills by people who lend the capital to *A* (or pay reparations). There will also probably be a secondary credit expansion in *A* and restriction in *B*. These changes in buying power[3]—which will

[1] The order of succession is an important question and distinct from that of the *size* of the changes in buying power.

[2] It makes no difference if *A* buys bills on *B* instead.

[3] The monetary mechanism of these credit variations can, of course, differ. The case in the text is merely an example.

probably be much greater than the amount of the borrowings and reparations payments, a fact which Mr. Keynes seems to overlook—can occur before the commodity movements take place and tend to bring them about in the way indicated above.

Evidently it is not true that there can be no changes in buying power except in so far as the real transfer is already solved by means of supply reactions. On the contrary, the changes in buying power, which are partly, at least, in a real if not in a formal sense a transfer of buying power from one country to another, are essential sides of the mechanism which brings about the real transfer of commodities. The changed credit policy [1]—restricting in B, expanding in A—affects buying power and, thereby, the balance of trade, independently of any effects on price conditions.[2]

On the other hand, it is, of course, true that the buying power is used up in the same proportion as the real transfer takes place. But, that does not mean that it has had no effect, as Mr. Keynes seems to think. Surely it is easier to sell many goods to a man who has got increased buying power, even though after buying them he has no longer greater buying power than he used to have!

§ 4. In his rejoinder in the June issue Mr. Keynes seems to make a slight concession—tacitly implied, perhaps, in his first paper—concerning the influence of *demand* reactions, as he remarks in passing that there will be a certain "reduction in consumption directly caused by the reparation taxes" (p. 179), and that "a reduction in the real wages of the German workers will cause them to consume less; a part of this reduced consumption will have the effect of benefiting the balance of trade" (p. 180). It follows from what I have said above that, in my opinion, this concession does not go far enough.

Note also that the second demand reaction—due to lower real wages—is to a large extent identical with the first one. Real wages fall because the workers bear a part of the burden of reparations. A further reduction in real wages can only occur in so far as Germany loses owing to less advantageous terms of exchange in international trade. This last wage reduction cannot, therefore, help to bring about the increase of exports relative to imports, which is necessary to pay reparations, but

[1] Certainly such changes in credit policy are *possible*. They may not be inevitable, but that is no argument. Surely it is the idea that Central Banks should make transfer as easy as they can.

[2] But changed price conditions will probably in some cases *help* to bring about the adjustment of the trade balance.

can only help to make good the extra deficit due to unfavourable terms of exchange.

Another necessary qualification to the whole of Mr. Keynes' reasoning is that not only wages, but other incomes as well, *e.g.* those accruing to the owners of fixed capital, can be reduced. The use of the classical labour value theory in international trade discussions has made it common to reason as if changes in incomes were identical with changes in wages.

§ 5. After the parenthesis in § 4 let me turn to Mr. Keynes' second line of defence against my criticism. His argument here is entirely different from the one discussed in the first three sections above. "If Germany borrows less, the first effect" will "be to bring in the Transfer Protection Clauses of the Dawes scheme. If so, the result would be that she would, for the time being at least, pay less Reparations" (p. 180). And later: "If Germany's foreign borrowing falls off, so, simultaneously, will her Reparation payments," except in so far as factors on the supply side operate.

I admit that I fail to see the justification for this assertion. Certainly if there is some mechanism by which a falling off in German borrowings "improves" her balance of trade, the reparation payments can go on. So until Mr. Keynes has proved that there is no such mechanism, the sentences I have now quoted are no argument at all. They are therefore irrelevant, if his other line of reasoning is not valid.

Of course there will be a "time lag" between the reduction of borrowings and the improvement in the balance of trade. But nothing prevents Germany from going on with reparation payments during that period, using a part of her reserves of foreign exchanges and gold. If she does, the changes in buying power will occur and the rest of the consequences I have indicated follow. Unless her borrowings cease suddenly, there seems to me to be no reason for assuming that the reparation payments would have to stop or even to be reduced.

In conclusion, therefore, I must uphold my contention that reactions on the demand side play their very important part in the mechanism of international capital movements just as well as reactions on the supply side. In my opinion, there has been a tendency to overlook[1] the former and to concentrate attention

[1] Ricardo alone among the prominent classical economists was an exception. He never accepted the orthodox price level variation mechanism in the case of subsidies and crop failures, but attempted to show that a more automatic and smoother adjustment would take place. Although he was not very explicit on this question and made certain untenable statements, it seems probable that

on the latter, with the consequence that a too sceptical view of the possibilities of such movements on a large scale has been taken. Anyhow, the clearing up of the theoretical difficulties involved is a matter of considerable practical importance not only for the handling of the reparation payments, but also for central banking policy in the future.

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III. A REPLY BY MR. KEYNES

My original article on "The German Transfer Problem" in the ECONOMIC JOURNAL for March, 1929, applied general principles to a particular case, without attempting to go deeply into the general principles themselves or even to enunciate them in a generalised form. As, however, the controversy, to which this article has given rise, develops—originally with Professor Ohlin of Copenhagen and now with M. Jacques Rueff of the University of Paris—the worst of it is that it moves, quite inevitably, from the particular to the general, so that full justice cannot be done to the points which have been raised without embarking on the general theory of International Transfers. Yet considerations of space forbid that I should attack so heavy a matter merely as a tailpiece to a particular piece of applied economics.

I must, therefore, do my best to indicate very briefly in what respects I cannot accept the criticisms of my commentators, apologising to them at the same time for not entering more profoundly into the general question and for certain unavoidable obscurities which they find in my treatment, due in part to the fact that my theoretical background in approaching these problems is as yet unpublished.

With M. Rueff's article I have the following differences of opinion :—

1. He misunderstands me in supposing that I agree with him that, when the adjustments are complete, the prices of all com-

he had in mind that reactions on the demand side would reduce the need for gold flows and price level changes. Bastable was perhaps the first to develop this idea clearly, although briefly, in "On Some Applications of the Theory of International Trade," *Quarterly Journal of Economics*, 1885. Curiously enough, there is no trace of it in his "International Trade." Wicksell's paper in the same Journal of 1918, "International Freights and Prices," is built on the same idea, which has lately played a certain part in the German discussion of the reparation problem.

modities within Germany will have been affected *equally*. It is of the essence of my argument that this should not be so, but that, on the contrary, the prices of home-produced goods in Germany should fall relatively to the prices of imports. For it is not simply a case of changing the value of money all round, but of changing the terms of international trade in a direction unfavourable to Germany, so that a larger quantity of exports than before will have to be offered for a given quantity of imports.

That real-wages in Germany will have to fall *less* than money-wages, I did indeed point out; for the prices of some of the goods on which German workers spend their earnings will have fallen *pari passu* with wages. But it does not therefore follow—as M. Rueff seems to suppose—that real-wages will not have to fall at all, and that it is merely a question of changing the value of money.

2. It follows that I do not accept "the principle of the conservation of purchasing power" in the form in which he states it. For I hold that the process of paying the debt has the effect of causing the money in which the debt is expressed to be worth a larger quantity of German-produced goods than it was before or would have been apart from the payment of the debt; so that the population of the debtor State suffers a loss of purchasing power greater than the original equivalent of the amount of the debt. Indeed if the world's demand for German goods has an elasticity of less than unity, there is *no* quantity of German-produced goods, however great in volume, which has a sufficient selling-value on the world market, so that the only expedient open to Germany would be to cut down her imports and consume home-produced substitutes, however inferior, and at an enhanced real-cost, however great.

3. There remain M. Rueff's historical instances designed to show that I have exaggerated the difficulty of bringing about economic re-adjustments. I agree that one has to be on one's guard against exaggerations of this kind. War and post-war experiences have provided us with instances of extraordinarily great readjustments successfully accomplished. But I must plead that I did not declare that such readjustments were *impossible*—only that they were *difficult*. I do not maintain that it is *impossible* to reduce German wages—after all, they have been far lower than their present figure within quite a short time ago—only that it is politically and humanly difficult (especially if one is cut off from the use of the weapon of currency depreciation), that this problem is distinct from the budgetary problem, and that the

extent to which the selling-prices of German goods will have to be reduced is the measure of the severity of the transfer problem.

I must, however, point out that M. Rueff's principal example—namely, France's readjustment to her post-war position—is quite exceptionally ill-adapted for the purpose of proving his point that such readjustments are *easy*. The violent social disturbances, the enormous redistribution of fortunes, and the wholesale disappointment of pre-existing contracts, which attended the prolonged and disastrous story of the depreciation of the franc to a fifth of its previous value, hardly afford a happy example of the *ease* of adjusting things. How short memories are, that M. Rueff, himself a Frenchman, should cite the post-war economic history of France in order to prove that economic readjustments are as easy as shelling peas!

Moreover there were certain features of the French situation, favourable to the establishment of a new equilibrium, which have no counterpart in the German situation. In the first place, the Dawes Scheme cuts Germany off from the use of currency depreciation, which is the one really potent method for changing at a *coup* the whole of a country's existing wage-structure. In the second place, the new adjustment in France did not require any permanent reduction of the level of real-wages. In the third place, the depreciation of the franc had the effect of actually getting rid of one of the principal difficulties, namely the excessive sums which the taxpayer owed to the *rentier*.

In fact where a country's difficulties are due to its owing a burdensome sum, readjustment is often brought about by its just not paying it. These are the precedents relevant to the German case, if it is historical precedents that M. Rueff wants. When the debt is owed in terms of the home currency, the relief comes by depreciating the currency; when it is owed in terms of a foreign currency, the relief comes by default. The majority of the countries which were heavy borrowers abroad during the nineteenth century found themselves at one time or another in the same sort of difficulty as that which I foresee for Germany, though on a much smaller scale, and they frequently escaped from it by defaulting more or less. If M. Rueff will read the reports of the Council of Foreign Bondholders, he will find that history is on my side, not his.

There are some sentences in M. Rueff's article which might be taken to attribute to me the belief that international balances of indebtedness do not always balance. They must, of course, balance precisely, every day of the year—unless some sort of a default takes place. What I am suggesting is that it may prove *difficult* to avoid this way out. As I have said above, countries, much less hardly pressed than Germany will be, have often availed themselves of this resort.

Professor Ohlin's contribution raises quite a different sort of point. As before, I find it extremely difficult to be sure just what he means. Let me try to narrow the possible points of difference by expressing my own point of view in a way which most nearly meets his.

I do not maintain—as he seems in his first paragraph to think I do—that the requisite change in Germany's balance of trade must necessarily be brought about solely by an adaptation of supply conditions without any assistance from demand conditions. I have always been careful to say that prices in Germany must fall, not absolutely, but relatively to prices abroad. But I admit that I have attributed to changes in demand conditions very little practical importance in the particular instances before us.

If Germany was in a position to export large quantities of gold or if foreign balances in Germany were acceptable to foreign Central Banks as a substitute for gold in their reserves, then it would be a different matter. For if Germany could set the ball rolling by exporting sufficiently large quantities of gold to have an appreciable effect on world prices, this, I agree, might help the situation by changing demand conditions. But I was assuming that what Germany could do along these lines would be, in fact, quite negligible. Professor Ohlin's analogy of capital movements between two districts with the same currency system would only apply if Germany were in a position to export enough gold to make a measurable difference to demand conditions in the rest of the world.

This is where the difference of opinion between Professor Ohlin and myself comes to a head. He argues (in his § 3) that even if gold does not flow on a significant scale, credit will nevertheless expand in the reparation-receiving countries. But why? Of course if *B* (Germany) can pay *A* (the reparation-receiving countries) in foreign bills expressed in the currency of a third country, there is no difficulty. But this is begging the whole question. The problem arises precisely because, on our hypothesis, Germany has no such foreign bills. Germany can only acquire such bills if she has already sold the necessary exports; so that these bills cannot be part of the mechanism which is to establish the situation which will permit her to sell the exports. I can make nothing useful of Professor Ohlin's § 3.

Finally let me remind him that even in so far as Germany can affect demand conditions in the reparation-receiving countries by exporting to them gold or its equivalent in foreign bills, this puts her at no advantage compared with all the rest of the world other than the reparation-receiving countries. There is the whole of the rest of the world in purchasing from which the receiving countries can employ their increased buying power. So we are, even in this case (which I cannot admit to be quantitatively important), brought back to the (to my way of thinking) crucial question of the extent of the elasticity of the world-demand for German exports. Professor Ohlin has not expressed any opinion about the extent of this elasticity or whether he thinks it important. Yet—on the assumption that Germany will have to increase her exports of finished goods by more than 40 per cent. to pay reparations without borrowing—this is to me the kernel of the whole problem.

As regards the final paragraph his § 4, I agree with him that a reduction in German incomes other than wage-incomes would be equally effective, provided the incomes in question are the earnings of a factor of production, so that a reduction in them lowers the costs of the German entrepreneur. But this proviso takes away practical significance from his observation; for there is not much likelihood of rates of interest in Germany being lower than elsewhere.

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